QV UPDATE

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QV Investors Inc.

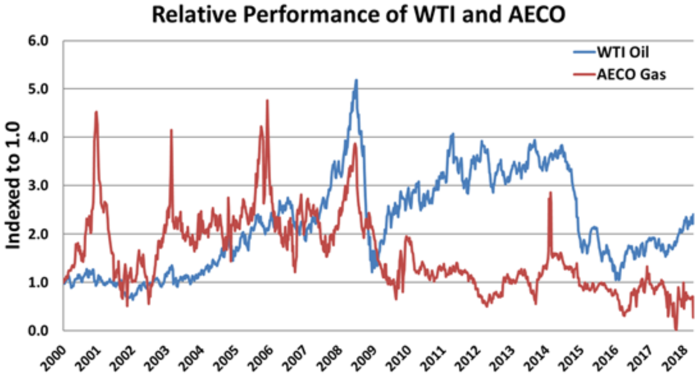
On Big Macs, Opportunity and Survivorship

In 1986, *The Economist* invented the lighthearted Big Mac Index, which tracks the USD equivalent price of a McDonald's Big Mac burger across multiple countries based on prevailing exchange rates. The theory is that, over the long term, an identical basket of goods (in this case, a burger) should sell for roughly the same price in constant currency across geographies. Significant price differentials therefore mean something is out of balance – a country's currency is either over or undervalued, or perhaps there are simply too many or too few local McDonald's franchisees.

Today, if you wanted to buy the equivalent of a thousand cubic feet (Mcf) of natural gas, you would pay roughly US$3 if you lived somewhere in Louisiana. That same product sells for about US$7 in Europe, over US$10 in Asia, but less than US$1.50 in Canada. One could conclude that either the Canadian dollar is vastly undervalued or that Canadian natural gas producers as a whole are making insufficient returns on their investments.

The reasons why Canadian gas sells at a substantial discount relative to other markets are complex, and there are no quick solutions. The difficulties in transporting product to other markets, lack of localized industrial demand, and the substantial growth of natural gas production all contribute to the price discrepancy. Indeed, while the decline in the price of oil tends to dominate the headlines, it is worth highlighting that WTI (the main US oil benchmark) has "only" fallen by 53% from its highest peak ($140 per bbl in 2008) to today ($68 per bbl). The real underperforming commodity has been natural gas, in particular Canadian gas. Alberta gas peaked in 2006 at C$12.13 per Mcf and is now approximately C$0.72 per Mcf, 94% off its peak. Is the weakness in Canadian natural gas due to expectations of slumping global or regional demand? No, in fact global consumption of natural gas has increased by 2.3% per annum since 1990, twice the growth rate of oil consumption. Based on BP Energy's 2018 Outlook, natural gas is set to continue to grow by 1.6% per annum through 2040, outpacing growth of oil by a factor of two.

Relative Performance of WTI and AECO



Source: Bloomberg

At QV, we tend not to make large macro-economic forecasts and, perhaps more importantly, our investments don't rely on our ability to accurately forecast any one specific variable – for example, the price of an underlying commodity. We do, however, subscribe to the idea of mean reversion; excessively high returns tend to normalize downwards and excessively low returns tend to normalize upwards over the long term. How the industry will normalize, however, is debateable. Many say that the answer is more infrastructure. Others suggest that the highest cost producers of natural gas should pursue different businesses – cannabis production perhaps? Others advocate for stimulation of more demand. Each of these solutions has its merits and we won't try to predict which path(s) will or should ultimately be pursued. What we do know is that regardless of the path, the winners will always be the producers that can survive in the toughest parts of a commodity cycle. To that end, we recently initiated a position in Peyto Exploration & Development, a low cost natural gas producer with assets concentrated in Alberta. We believe Peyto's assets will remain resilient in a sustained low natural gas price environment and will be one of the survivors standing at the end of this tough gas price environment.

In 1996, gas was $2.50 per Mcf, oil was $20 per bbl and there were 47 companies in the TSX producers index (a composite of the largest oil and gas producers at the time). Today, gas is $3.00 per Mcf, oil is $68 per bbl, yet only five of the original 47 are still in the index. On average, those five have outperformed the broader producers index and the TSX Composite by 10% per annum and 3.5% per annum, respectively, over the last 22 years. Survivorship tends to lead to stronger returns and we believe that the shareholders of the most defensive natural gas producers will be rewarded over time.